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C O N F I D E N T I A L SECTION 01 OF 02 ANKARA 005736

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SUBJECT: CENTRAL BANK GOVERNOR TO AMBASSADOR: WE'VE MADE
PROGRESS, BUT NOT ENOUGH

REF: ANKARA 5641

(U) Classified by Ambassador Eric Edelman. Reasons: 1.5(b,d).

1. (C) Summary: Central Bank Governor Serdengecti told Ambassador September 9 that Turkey had made progress on a number of economic issues, but he remains cautious because "anything can happen." On the positive side, the economy is enjoying both growth and disinflation, the government has increasingly accepted the need to stick to the IMF program, and people are starting to see the benefits of sound policies. On the other hand, some circles continue to lobby against the disinflation effort, the government's failure to fully grasp and communicate the value of the reform program is weighing on market confidence, and the Central Bank's independence must be defended every day. Serdengecti warned that the Imar Bank scandal had damaged the BRSA's credibility, and may result in the departure of the BRSA leadership. He reiterated his concern about anti-Americanism and, more broadly, about elements within the State -- particularly in the bureaucracy and judiciary -- who favor isolationism and oppose foreign investment. End Summary.

2. (C) During Ambassador's September 9 courtesy call on Central Bank Governor Sureyya Serdengecti, the Governor caveated his generally positive description of economic trends with numerous words of caution. He noted that the economy was enjoying not only a downward trend in inflation, but also solid growth, which few had expected. However, since in Turkey "you are penalized for being successful," important lobbies who have benefited from chronic inflation were constantly criticizing the Bank and pressing for a more relaxed approach to disinflation.

3. (C) Serdengecti said that six months ago, the government had not understood the value of the economic reform program. Its approach was to obtain U.S. financial support, then get rid of the IMF so it could pursue populist policies. Since the Iraq operation, the political leadership has increasingly understood the need to stick to the program, though "we still aren't 100 percent there." Government leaders have a hard time understanding economic issues, and do not trust people outside their circle. "We still have to lecture them all the time." They have made progress, "but it's not enough. Anything can happen."

4. (C) Ambassador said he had been encouraged by his recent conversation with Minister Babacan (reftel), who appeared upbeat about the Prime Minister's willingness to support efforts to hold down spending. Serdengecti responded that Babacan was lucky, in that his position overseeing the Treasury meant that he had been lectured constantly (by Serdengecti and Treasury technocrats). As a result, he was the first to learn the need to stick to the reform program.

5. (C) Serdengecti said the upcoming 6th review was critical. The Bank is becoming more confident about inflation, so is tempted to cut interest rates again. However, having seen delays leading up to the 5th review, he remains skeptical of the government's commitment and wants to see "more performance" before cutting rates. Unfortunately, the government's habit is to wait until the last two weeks to take the actions needed to meet Fund conditions.

6. (C) Noting that privatizations were a key aspect of the upcoming review, Ambassador suggested it would make sense for the government to start the privatization process now, rather than wait until the last minute, so as to reduce the risk of being criticized for selling state assets for too low a price. Serdengecti agreed, saying the only way to avoid such criticism was to implement the privatizations in a

steady, fully transparent manner.

17. (C) The Governor said he was not too concerned about the lira's strength, which he said was being driven by a combination of reverse currency substitution, inflows of Turkish-owned capital that had been stashed abroad, and seasonal factors, notably tourism. Exporters constantly complain, but that is because they are used to the Central Bank focusing on the exchange rate rather than inflation. If Turkey had a fixed exchange rate, the growing current account deficit would be a concern. However, with a floating rate, if people become convinced the lira is overvalued, they will start to sell, and the exchange rate will correct itself.

18. (C) In response to Ambassador's question, Serdengeçti highlighted three continuing concerns:

-- powerful lobby groups fighting the Bank's disinflation efforts. Some exporters, along with certain local industry and trade groups, have benefited from chronic inflation, because it has enabled them to shift the cost of their mistakes to others (such as labor unions). The Bank is getting a stronger hand in this war, but remains cautious because these groups are lobbying the Prime Minister's office to adopt a less aggressive anti-inflation strategy.

-- the continuing lack of confidence in the government, despite the progress noted above;

-- the Bank's independence, which he said he has to protect every day. "We've come a long way, but it's not enough."

19. (C) Ambassador asked about the impact of the Imar Bank scandal on the Banking Regulation and Supervisory Agency (BRSA). Serdengeçti said he feared the damage was significant, and BRSA's leadership might have to quit as a result. He noted that the agency had been under constant pressure, and is now paying a price for the Imar Bank mess. Serdengeçti stressed that government agencies have been aware of the bank's problems for years, and predicted that the public would learn "many things" when this case goes to court. He cautioned that the government and the IMF needed to handle this case carefully, because it would be a big mistake if the government derived the wrong lessons and blamed the BRSA, which is only partly at fault here.

110. (C) Ambassador noted that, while the government appeared content to pursue corruption charges against former officials and, now, the Uzans, the real test would be whether it was willing to go after its own people should evidence of corruption arise. Serdengeçti said he had told the Prime Minister and Minister Babacan that they should see this case not as an opportunity to weaken the BRSA, but as a chance to explain to the public the enormity of the corruption problem. This approach, however, requires an understanding of the critical importance of structural reforms, particularly establishment of strong institutions, which the government appears to lack.

111. (C) Serdengeçti expressed concern at growing anti-Americanism in Turkey, saying people had quickly forgotten how Turkey had survived during the last 50 years. He joked that, during the Cold War, Turks could always blame problems on the USSR. Now that it was gone, only America was left to blame. Of even greater concern, he said, is that some "important circles" that oppose Turkey's reforms and global integration are pressing for a return to isolationism. Although Turkey had no choice but to enter alliances after World War II, certain elements of the secular establishment have always resisted integration. This resistance continues today, deeply entrenched in the State, in the form of opposition to reform and foreign investment. Even as Turkey liberalizes legislation on foreign investment, important forces in the bureaucracy and judiciary undermine the effort through their actions. Successive governments, including the current one, have failed to explain to the public the benefits of global integration and reform, making it easy for people such as Cem Uzan to campaign on an anti-IMF, anti-globalization platform.

EDELMAN